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Procedia - Social and Behavioral Sciences 221 (2016) 262 – 269
Procedia Social and Behavioral Sciences

SIM 2015 / 13th International Symposium in Management

Local Tax Policy in the Function of Development of Municipalities in Serbia

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Abstract

The state and local communities must have an active tax policy to contribute to the achievement of their economic and social objectives, whereby they have to find an adequate measure as not to jeopardize the economic and market principles and a favorable economic environment. In conducting the tax policy, priority should be given to built-in incentive instruments in relation to the "ad hoc" measures of tax competition. The practice of giving subsidies and tax incentives in the near past in Serbia has not yielded satisfactory results: extremely high rate of unemployment, low level of GDP per capita, high indebtedness and foreign trade deficit. Because of this, the local government in the coming period must have a much more active role in managing local tax policy in order to stop the negative economic trends and standards of their population. We argue that the highest degree of efficiency is achieved, if the fiscal policy measures are in correlation with economic and structural policies and have a strong synergetic effect.
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Peer-review under responsibility of SIM 2015 / 13th International Symposium in Management

Keywords: tax policy; local economic development; competitiveness; tax competition.

1. Introduction

Sustainable economic development implies reducing irrational and unproductive expenditure while increasing investment spending in order to stimulate growth and employment, with social protection of the most vulnerable layers of the population. The key role in this have fiscal policy and structural reforms with the defined measures in the short, medium and long term about which there is agreement of the participants of social dialogue (Government,

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Peer-review under responsibility of SIM 2015 / 13th International Symposium in Management
doi:10.1016/j.sbspro.2016.05.114

employers, trade unions) and the wider professional community. Tax policy should contribute to remove the key macroeconomic imbalances of the Serbian economy - high unemployment rate and high foreign trade deficit while at the same time not jeopardizing the international competitiveness of companies and a favorable economic environment. Tax policy of Serbia in the forthcoming period should provide long-term sustainable development of the economy that will be based on increasing exports and investments, and decreasing the unemployment rate and the foreign trade deficit. (Janeba, & Osterloh, 2013) proposed a new theoretical model of tax competition at the local level. Their model predicts – contrary to earlier findings for competition between countries or regions – that capital tax of large jurisdictions fall more strongly with increasing interregional competition and may eventually lead to smaller taxes than in small jurisdictions. The effects of tax policy must result in increasing the international competitiveness of the economy while maintaining a favorable economic environment, primarily to attract domestic and foreign direct investment. Improving the tax system is a continuous process due to the fact that modern business processes lead to the creation of new issues related to taxation. Necessary reforms must be carried out both at the state and at the local level. (Ojede, & Yamarik, 2012) examined the impact of different taxes on state economic growth. They used data from 48 states in the US within a pooled mean group to estimate short-run and long-run coefficients. Their findings were that sales and property taxes have a long-run effect on growth. Study of (*Dennis C. et al. 2011)* finds that the effective state and local tax rate of income households as a percentage of the effective state and local tax rate of income households is significantly influenced by whether a state has a multirate income tax, right-to-work laws, the liberalism of a state's electorate, the average tax burden in a state and past tax policy.

Local tax policy should be adequate, with a predictable amount of tax and incentive for activities that are dominant in the local economic structure. When formulating local tax policy also to be borne in mind is the effect of other factors on local economic development such as financial support to enterprises, training and retraining, development of local infrastructure, incentives for innovation and development and other. Priority should be given to those measures of fiscal policy that contain automatically built incentive instruments because they reduce investment uncertainty, decrease the time of investment planning, reduce possibilities for corruption and influence the reduction of administrative costs.

2. The structure of the tax system

The tax is the most important part of public revenues in modern states and with it state provides funds to finance public expenditures (Bozidar, 2008). The tax is an instrument of public revenue by which the state, including lower forms of political territorial organization, forcibly takes cash assets from the entities under its tax authority, with no immediate favor, in order to cover its financial needs and achieving other, mainly economic and social objectives. (Popović, & Popov, 1995). The tax system of a country makes the totality of all forms of public revenues and taxes and is used to cover the costs of general social importance. The tax system is based on the concept of equality and the concept of efficiency. The concept of equality should provide the answer to the question: whether the tax is fair? The concept of efficiency gives the answer to the question what is the amount of tax an individual must pay that it would be better for him with tax than without it. State and/or local government should choose the development of the tax system that serves the broad needs of society in an efficient and equitable manner. The portfolio taxes (Stallmann, & Jonson, 2011), similar to the portfolio of investments, enables balancing the negative aspects of a tax with the positive aspects of another tax. The choice of the taxation system for state and local revenues is a process of compromise between the following desirable features:

- administrative simplicity – that tax is easily collected and administered,
- competitiveness - whether tax encourages companies and individuals to leave the local government or limits its ability to attract business?
- efficiency - whether the tax affects the efficient allocation of resources and consumer choices?
- revenue adequacy - whether tax revenues enable the state to meet the needs of its citizens?
- equity – whether it is tax fair?

The structure of the tax system shows that taxes are present in the tax system and the extent of their significance. There are several factors that determine the structure of the tax system of which the most important are: the level of development of the economy, the degree of marketability of the economy, the education level of the population, labor force structure, manner of social security financing, in particular of the pension system, the structure of the state, state involvement in international integration, the size of government, tradition, etc. Changes in the structure of tax system are affected by changes in economic institutions and commercial entities. The structure of the tax system is very important because it often happens that a change in the tax structure seeks to achieve an impression of reducing the overall tax burden. The structure of Serbia's tax system has three levels and the affiliation to the levels is seen in the following Table 1. National and local tax structures must be seen as a family of taxes and the balance is achieved by relying on different tax bases.

Table 1. The structure of the tax system of Serbia.

The national taxes	Provincial taxes	Local taxes
Value added tax Tax on income (on income from dividends and shares in profits, interest income, the income from copyright, capital gains, the annual income of citizens) Corporate income tax Excises Tax on the use, possession and carrying of certain goods Tax on international trade and transactions The taxes shared between the central and provincial authorities Part of the corporate income tax Part of the personal income tax The taxes shared between the central and local authorities Tax on income (tax on earning)		Property tax Tax on transfer of absolute rights, Inheritance tax Income tax (on income from self-employment, revenues from real estate, other revenues, on land, on the issue of movables, on income from personal insurance)

The structure of tax systems of EU member states is heterogeneous, with significant differences. Particularly significant differences are between the old and new EU member states (Spiric, 2011). In the old EU member states on average the most significant taxes include: social insurance contributions (about 28%), income taxes (about 25%), VAT (19%), special consumption taxes - excise taxes (about 10%), profit tax (9%). In the countries - the old EU Member States dominate direct taxes (including contributions) in relation to indirect (VAT and excise tax), compared to approximately 2:1. In the new EU Member States indirect taxes are more significant in relation to direct. The relationship between direct and indirect taxes in the 12 new EU member states is 1.35:1, and in Serbia 1.15:1. The greater importance of indirect taxes in the countries in transition is in accordance with giving the advantage to the economic benefits in relation to social objectives in these countries.

Table 2 Revenues of the Republic of Serbia in the period 2012-2013

Budget revenues	2012	2013
1. Tax revenues	686.828,2	723.389,7
Personal income tax	46.432,4	43.376,6
Corporate income tax	48.802,8	53.214,0
Value added tax	367.471,8	380.624,3
Excises	180.627,9	204.760,9
Customs duties	35.782,8	32.504,3
Other tax revenues	7.710,5	8.909,6
2. Non-tax revenues	99.285,5	87.338,0
3. Donations	2.388,3	1.353,0
Total budget revenues	788.505,0	812.080,7

Source: The National Bank of Serbia, Department for Monetary Analysis and Statistics, 2014.

Giving priority to economic goals (rapid growth, reduction of unemployment, etc.) reflects the intention of these countries to eliminate the backlog in the level of development compared to the old EU member states. The data in Table 2 show that in 2013, there was a growth in tax revenues of 5.32% compared to the previous year. Separately, the biggest growth was recorded by excises 13,36%, while the VAT increase was modest 3.57%. In the structure of tax revenues the largest share of 52.62% have VAT and excise duties with 28.30%, while the share of corporate income tax and personal income tax is significantly lower and amounts to 7.35% and 6.0% respectively.

Estimates of gray economy in developed EU countries range from 10 to 15% of GDP. However, the underground economy is far more present in countries in transition and in Serbia it is around 30% of GDP (Arsic, et al. 2010). The significant presence of gray economy hinders efficient allocation of resources and slows down economic development - because economic subjects prone to tax evasion constitute unfair competition to the economy, which operates in the legal flows. The gray economy significantly distorts the concepts of economic policy, which we have witnessed both in Serbia and in the immediate environment, throughout the transition period.

3. Local public finances in the transition period

The main levers of macroeconomic policy of each country are tax (fiscal) and monetary and credit policy Tax policy is part of economic and social policy. Tax policy includes harmonized functioning of state institutions through the influence of public revenues on the distribution, exchange, consumption and production in a given national space and time in accordance with the socially acceptable aims and objectives. A wide range of impacts of tax policy instruments contributes by their implementation the realization of three essential functions and *(Vukadin, E. 1991)*: stabilization, allocative and redistributive. Tax policy is an instrument of control and rules of behavior in the economy and the local community.

At the same time, the local tax policy is a part of, i.e. segment of the national tax policy. States and local communities must take an active fiscal policy to contribute to the achievement of economic and social objectives. However, they must find an adequate measure as not to jeopardize the economic and market principles, since tax policy is not and cannot be a substitute for economic policy.

- The characteristics of "good" local tax *(Sexton T. 2006)* policy are:
- stable with visible tax bases,
- equitable with fair tax burden,
- adequate with predictable amounts of taxes,
- simple,
- recognizable, among the citizens and the economy, not only locally,
- stimulative for the desired economic activity (business activity),
- systematic and metered use of tax relief.

In formulating local tax policy one should start from the assessment of one's own strengths and weaknesses situational conditions should be assessed in which the local authorities function, the competitive position of other local governments should be assessed, especially geographically close, and then approach to planning of fiscal policy. Assessment of possible comparative advantages may enable the achievement of the desired effects without the tax cuts, using the unique assets that are owned. The rare resources need not be exclusively natural, even more desirable are the so called soft resources, related to people and technology. Municipal development strategy is a document in which answers can be found on the largest part of the question about resources, local strengths and weaknesses of certain authority. This plan provides an answer even to the most important question for the formulation of tax policy and that is the direction of development and business activities that are dominant in the local economic structure. The aim is to encourage local governments to implement the planned restructuring of local public companies. This would ensure a reduction in subsidies to these companies and improve the quality of their services. The possibility of an optimal combination of taxation and diversification by providing good public services was confirmed in a study from 2004. (Benasyy, et al. 2004) found that the growth in public investment as a share of total public expenditure by 1 percentage point increases the inflow of foreign direct investment by 13%. Therefore, the country can at the same time raise the average effective tax rate (EATR) for four percentage points and public investment by 1 percentage point, while maintaining the same amount of investment.

The local tax portfolio consists of taxes paid by citizens and business taxes. One of the most difficult decisions in the formulation of tax policy is to find the balance between taxes for citizens and tax for the economy. Business taxes are very popular among local taxes. The advantage of these taxes is easy administration, and they are politically acceptable because they do not directly affect the citizens (voters). Policymakers must take into account the possible expansion of the tax bases and coverage of taxpayers. At the same time, the mobility of resources must be borne in mind, particularly of labor, as well as the possibility that a State may by law determine the upper limits of certain laws. The analysis should include many non-tax factors, among which the demographic factor stands out. The most important measures to improve the local public finances are improving expenditure control at the local level and limiting the growth in employment, salaries and subsidies to local governments, as well as the transfer of certain competences of the Republic to the local self-government in the area of transport infrastructure, education, health and social protection.

Necessary segments are also the improvement of public policies at the local level and increasing the efficiency of services provided by local governments through higher investment in local development projects and increase of cost efficiency of investments. At the local public finances in Serbia extremely negative impact had failed privatization because it affected a significant reduction in the number of taxpayers. Local governments have attempted to compensate this lack by the introduction of new fiscal and para-fiscal levies on the remaining businesses. The additional effect of unsuccessful privatization was the reduction of the fiscal autonomy of local governments, because there has been a massive decline in employment and thus the reduced share of taxes on earnings in the current revenues. All this has caused the high indebtedness of local governments (Table 3) given their economic strength and forecasts for future economic trends.

Table 3 Public debt state of local government on the day 30.09.2014

A.1. INTERNAL DEBT	
Description of liabilities	The debt in RSD
Securities issued in domestic market	12.296.362.992
Loans to commercial banks to finance liquidity	419.335.994
Loans to commercial banks for the financing of capital investment expenditures	27.189.923.082
Internal debt (A.1.)	39.905.622.067
A.2. EXTERNAL DEBT	
The European Bank for Reconstruction and Development	15.312.820.211
European Investment Bank	27.566.776.011
External debt (A.2.)	42.879.596.222
TOTAL LIABILITIES (A.1+ A.2.)	82.785.218.289

Source: Ministry of Finance, Public Debt Administration: The quarterly report to the state and structure of public debt at 30.09.2014

Out of the total debt (Table 2) in 2015 due for the return is 11,989,754,312 dinars and in 2016, the amount is 10,951,567,376 dinars, without interest. The percentage of debt subject to changes in interest rates is 55.7% and to currency risk even 78.8% The share of foreign loans amounted to 52.1% and the share of 5 most indebted local governments in the total debt amounted to 80.2% (of which referring only to the Belgrade is 60.6% or 32,251 dinars per capita). An important segment of tax policy is to build and cultivate a tax ethics *(Lars P. et al. 2007)*. Local Tax policy should be set to develop the climate of voluntary payment of taxes. Such a scenario is possible if taxpayers see the government as a reliable and well-intentioned. The important elements of this system are tax knowledge, fostering and respect for social norms (Kirchler, 2007).

In other words, we should take into account the dynamic interaction of power and confidence, since, obviously, the designing of good tax policy is not possible by using only an economic approach. The data used as a basis for the development of the local tax policy must be multi-year since the data for one year are not very informative. Attention should be focused on the trends of local taxes. Every tax policy must aim to balance in the long term which means mechanisms should be incorporated that will allow the policy changes over time. In this respect, efforts should be made anticipate challenges and surprises as accurately as possible, on the basis of signals from the economy, households and public administration. Some of the future challenges of the local financial systems are: technological advances, globalization, deregulation of utilities and demographic changes. In formulating local tax policy other aspects that attract companies, excluding taxes should also be considered. In the world there are examples of Germany and France, which attract investments and the economy regardless of the high taxes. Often cited as the example is California, which has one of the highest tax burdens in the US, and manages to attract economic activity, as it has a competent workforce and a large market that is ready to consume. There are known cases of investment-motivated high level of public goods and services offered by the local communities. The high level of public good does not require additional costs by the companies, and thus contributes to their productivity. Public goods increase the productivity of companies, and productive capital tend less to mobility.

4. Local tax policy in the function of economic development

The role of the fiscal system and fiscal policy in stimulating the building of competitiveness is significant, particularly with respect to the effects of individual measures and ways of using incentives (Momirović, et al. 2009). The highest degree of efficiency is achieved, if the fiscal policy measures are in correlation with economic and structural policies and have a strong synergetic effect. With a clear and consistent structural policy the state can best and in the most effective way influence the development of the economy and its competitiveness. In the application of fiscal instruments, for the development of competitiveness, it is essential that the state in to the smallest extent possible uses ad hoc measures, and the more built-in incentives that have an endogenous character, the effect of which does not depend on the intervention of economic policy makers. Numerous authors question the validity of the approach which associates local development with the structure of the tax. According to them, the state and local taxes played an extremely minor role in shaping regional development patterns (Pomp, et al. 1979). The arguments for these conclusions the authors make from the following. Firstly, local taxes represent a symbolic part of the expenditures of companies.

Second, high taxes can reflect a high level of local public services (educational institutions that produce high-quality work force, cultural facilities, good transportation, stable energy supply, good telecommunications, water and sewerage) that can offset the high tax rates. Third, coming of companies that move frequently is not an important source of local development (Pomp, et al. 1979). The largest part of the local economic development comes from employment in existing enterprises, their extensions and the new companies founded by the native population. Fifth, the expansion of national infrastructure enables better connectivity with other markets, reducing transaction costs and contributes to the competitiveness of the local economy, while reducing the pressure for the emigration. Sixth, capable personnel, both in the part of efficient administration, as well as in the part of the labor market, are the most important factor of overall, as well as of local economic development.

The empirical literature addressing the relations of competitive tax rates and the provision of public goods and services is rather limited, but there is the study by (Gabe, et al. 2004) on the impact of public expenditures (investments) and the rate of property tax on the choice of location of companies in the state of Maine (USA). Result reached by the author's state that the increase in public spending in education for 10% would lead to an increase in the number of firms by 6%. According to them, the policy of low taxes and low levels of public services is less awarded by the adverse tax policy of high taxation with a high level of provision of public goods and services. The use of tax incentives is very old measure to attract investment. Tax incentives are increasing (Pomp, et al. 1979), but their use raises a number of questions. For example, whether the companies really choose a location based on state and local taxes, or they base their decision on other grounds. What percentages of operating costs represent state and local taxes? Further formulation of tax policy, and response to pressures to introduce tax incentives, must consider the factor of deadline and reactions of other local governments. Possible situation is that other jurisdictions introduce similar measures and the revenue would fall in each jurisdiction, and none would achieve competitive advantage. In introducing local tax incentives it is necessary to give an answer using an analysis for how much are the effects greater than the amount of subsidies, i.e. whether the benefits are commensurate with the income which the local community waives. Other issues that follow provision of tax benefits: whether the newcoming activities and investments are appropriate to community needs? Will the new companies employ local unemployed population? Are these business activities environmentally acceptable or they are about dirty technologies? Will the profit be reinvested in further development of the user of tax concessions? Tax incentives, as an instrument of state aid in the Republic of Serbia in 2013 accounted for 32.3%, and include the tax incentives granted under the Law on income tax of legal entities and the Law on income tax, through the reduction of personal income tax by investments in fixed assets (Table 4). From the data we see that the subsidies in 2013 were 63.6% and at most assigned to the sectors of agriculture, mining and transport.

Table 3 Public debt state of local government on the day 30.09.2014

Allocation instrument	2011. year		2012. year		2013. year	
	Amount	%	Amount	%	Amount	%
Subsidies	48.212	58,5	52.571	59,8	51.820	63,6
Tax incentives	25.296	30,7	28.660	32,6	26.316	32,3
Favourable loans	7.742	9,4	6.678	7,6	3.315	4,1
Warranties	1.198	1,4	0.0	0,0	0.0	0,0
Total	82.447	100	88.009	100	81.451	100

Source: Ministry of Finance, Report on state aid granted in the Republic of Serbia in 2013

Local tax incentives are only one of the means of providing state aid. Other possible instruments are: financial support, training and retraining, incentives for innovation and research and development, efficient administration, "one stop shop" service, programs of development of local infrastructure and other. Positive effects of incentives for local governments are reflected in hiring local skilled workforce, although in Serbia it is, usually, provided by very low wages, incomparably lower than for workers of the same company in the home country. (Hanberger, 2015) proposed a framework that explores the shaping of local safety policy in multi-level governance. The framework demonstrates one way of exploring what shapes LSP, reflecting the complex environment and contingencies of multi-level governance. It can be used to explore what intentions and knowledge shape LSPs, and identify governance problems and knowledge gaps.

On the other hand, the reduction of revenue in the budget due to tax incentives will be most felt by the poor. The unemployment rate in Serbia is extremely high, especially of young educated professionals. Financial support to programs for employment and self-employment of young people is extremely modest, opposite the great stimulation per new job created by foreign companies, often in labor-intensive industries that do not require high technology and other investments. In particular, it is symptomatic that it is given to companies that have already existed or that are extinguished by irresponsible and inefficient privatization (textile industry, footwear, etc.). Tax competition among the local governments is the competition in attracting capital using tax instruments, especially tax incentives.

Tax competition exists when there is allowed the improvement in the relative competitive position of one municipality against another, through reducing the tax burden on the business activities of companies and individuals, in order to retain or attract mobile economic activities, although it is often realized in a way that harms other local governments. The positive effects of tax competition are reducing the tax burden, fiscal discipline, innovation, an appropriate balance between the level of taxation and public goods. Tax competition has a growing importance for the growth of mobility of production factors. The effects of tax competition are measured by the degree of reduction of public spending, i.e. the degree of efficiency of the public sector.

The preferred tax competition is the one leading to a reduction in tax rates, with a parallel broadening of the tax base, but to an extent that does not affect the tax and budget policy of neighboring jurisdictions. The negative effects of fiscal competition (Roháč, 2006) are: First, international capital allocation becomes inefficient because capital goes into areas where the tax is lower, regardless of the real economic considerations, and, secondly, tax competition leads to a deterioration in the tax base and eventually causes below-average supply of public goods. The second argument is developed by the OECD. Tax competition can cause a range of adverse consequences that can occur due to the action of the so-called spillover effect and are reflected in the tax evasion, undermining the financial and investment flows, undermining the integrity and fairness of the tax structure, shifting the tax burden to the less mobile tax bases such as labor, assets and consumption. (Reynolds, & Rohlin, 2015) focused on importance of analyzing distributional effects of location-based tax policies along with mean changes when investigating location-based policies such as the federal EZ program. The results confirm the prior literature findings that the areas, on average, became more attractive but also suggest that the benefits of the program likely did not accrue to the lower-income residents of the EZ areas.

5. Summary

Tax policy should provide a steady flow of tax revenues without worsening economic environment and international competitiveness of the country. Measures of tax policy should encourage accumulation as the primary economic category, followed by investments in industries and sectors, and in Serbia through this policy the reduction of regional disparities must be more taken into account. Priority pressing task of tax policy, along with other segments of economic policy, is to stop the trend of growth of public debt to GDP ratio which since 2008 increased by 29.2% to as much as 63.8% in 2013 and threatens by unfavorable debt scenario. The role of the fiscal system and fiscal policy in stimulating the development of competitiveness is significant, particularly with respect to the effects of individual measures and ways of using incentives. With a clear and consistent structural policy the state can best and in the most effective manner influence the development of the economy and its competitiveness. In the application of fiscal instruments, for the development of competitiveness, it is essential that the state uses ad hoc measures to the smallest extent possible, and the more built-in incentives that have an endogenous character, the effect of which does not depend on the intervention of economic policy makers. Local tax policy during the transition period has not had a significant impact on overall economic trends in Serbia. In particular, it relates to privatization processes whose negative consequences affected most local governments in the form of huge unemployment, poverty, negative demographic trends, etc. Therefore, local tax policy must play a more active role in economic development with its measures complying with other "non-tax" instruments of economic policy. In doing so, priority should be given to the stability and predictability of tax in relation to over-provision of tax benefits the effects of which proved to be negative in practice.

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